First National City Bank
Monthly Letter

Business and Economic Conditions

New York, November, 1957

General Business Conditions

THE month of October has been characterized by growing recognition that the fall pickup in business is not materializing to the degree hoped for. While levels of production, trade, and employment continue high, complaints are more common that incoming orders are insufficient to support production, that order backlogs are running down and inventories are continuing a problem. In this environment, additions to productive capacity become surplus, temporarily, and widen the area of soft spots in the economy. Reports are becoming more frequent of stretchouts and postponements of expenditure programs for new plant and equipment. In short, business sentiment inclines toward caution. Many industrial leaders, including corporation executives on the Commerce Department's Business Advisory Council, are now recognizing the possibility that some moderate decline in general business activity may lie ahead.

This change in the business picture, coupled with the disquieting implications of the Russian success in launching an earth satellite and new tensions in the Middle East, has registered sharply on the stock exchanges. Prices there had become vulnerable, being based on highly optimistic projections of continuously expanding business volume and profits. With the widespread discussion of the cost-price squeeze on profit margins and the uncertain prospects for sales in some industries next year, stock prices have had to come into line with more conservative appraisals of the outlook. This weakness in the markets has reinforced the caution in business circles.

Boom Tapering

Up to September, the over-all value of the nation's output of goods and services was still rising. According to the Council of Economic Advisers, the gross national product figures for the third quarter reached a new record annual rate (seasonally adjusted) of $439 billion. This was $4.7 billion greater than in the second quarter and some $22 billion more than in the third quarter last year. Rising prices, however, accounted for a major share of these gains.

The increase from the second to the third quarter was almost entirely in the demand for consumer nondurable goods and services. Apart from state and local public works, the durable goods industries and construction have shown almost no rise since the first quarter of 1957. In fact, allowing for price increases, physical volume in these industries appears to have edged slightly lower.

During the generally sidewise movement of industry in the spring and summer, many persons looked hopefully for a better than usual increase in production and trade in the fall. Actually, on a seasonally adjusted basis, September fell below August in such varied and important business indicators as personal incomes, retail sales, total employment, industrial production, factory new orders and shipments, housing starts, and whole-

CONTENTS

sale prices. The size of the declines, which were mostly moderate, was not so significant as their preponderance over advances.

The showing of personal income and retail sales during September was disappointing to observers who had been counting on increased consumer spending to offset declines in other sectors of the economy in the months ahead. While the dip in income, which resulted mainly from payroll cutbacks in durable goods manufacturing, was small, it was significant because it was the first interruption in the upward trend. Seasonally adjusted retail sales declined 2 per cent in September from the record July-August level, but at $16.7 billion they were still 5½ per cent above September 1956.

Preliminary October department stores sales data failed to show any gain over the corresponding 1956 period. Apparently, seasonally adjusted sales for these stores for the full month will show a continuation of the decline registered in September, when the total was off 4 per cent from August. Retail automobile sales are also likely to be lower in October, but only because introduction dates for several new models are later this year than last.

In manufacturing, durable goods producers appear to be cutting production in line with declining order backlogs; not a single major durable goods industry registered an increase in output in September. Nondurable goods activity, on the other hand, rose to a new record. The net result was a decline of only 1 point in the Federal Reserve index of industrial production (seasonally adjusted, 1947-49 = 100) from 145 (revised) in August to 144 in September. Factories produced the same over-all volume in September as they did a year ago, while employing about 2 per cent fewer production workers on a slightly shorter work week.

Steel Operations Off Contraseasonally

By late October, steel mill operating schedules had slipped to 79 per cent of capacity from the average August-September rate of about 82 per cent. This weakness in a key industry, in a month when activity normally is rising to a seasonal peak, suggests that the industrial production index for October may show a further decline.

Steel orders have been disappointing all fall as durable goods manufacturers increasingly felt the effects of reduced ordering of capital goods and the strains involved in defense contract stretchouts and payment delays. Continued inventory reduction by steel-using industries is expected by Roger M. Blough, chairman of U.S. Steel Corporation, who estimated near the end of October that steel mill output may average below 80 per cent of capacity during the first half of 1958.

It would be premature to draw any conclusions on the extent of whatever downward adjustment may be in prospect. The September declines were generally small and some may disappear when preliminary figures are revised. In addition, temporary factors affected some important industries in that month. Activity in the automobile industry, for instance, was depressed by the annual model change, while unfavorable weather conditions adversely affected retail sales and harvest-time employment in the South. Although business plant and equipment spending may ease off, present indications are that the total volume of public and private construction will continue high.

As noted by Alfred Hayes, president of the Federal Reserve Bank of New York, in mid-October:

> It would seem that the greatest change in the last two or three months has been not in business statistics, which on the whole have changed very little, but in business sentiment, which has deteriorated appreciably and has been reflected in the declining trend of stock prices since early summer. This change of sentiment may not last, but to my mind it is a healthy development, if held within reasonable limits, after the rampant optimism of a few months ago.

While business generally is feeling increased caution regarding the short-term outlook, confidence in the long-range prospects for growth and expansion remains unimpaired. The boom has been restrained and readjustment hastened by the efforts of the Federal Government to hold expenditures within the public debt limit, combined with the Federal Reserve policy of limiting creation of additional money. Any marked decline in business can be expected to bring modification of fiscal and credit policies to encourage balanced and orderly growth. The ultimate objectives of such policies can hardly be attained, however, unless they lead to an easing of the excess pressures on resources and overexuberance that have been promoting the wage-price spiral.

Third Quarter Corporate Earnings

Corporate reports issued during the past month indicate that sales and earnings in the aggregate continued to be well maintained through the third quarter. Plus signs were less predominant, however, than in 1955 and 1956.

Statements of 810 companies released to date show combined net income after taxes of approximately $2.8 billion for the third quarter, a de-

NET INCOME OF LEADING CORPORATIONS FOR THE THIRD QUARTER AND FIRST NINE MONTHS
(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Reported Net Income Third Quarter 1956	Reported Net Income Third Quarter 1957	Per Cent Change†	Reported Net Income Nine Months 1956	Reported Net Income Nine Months 1957	Per Cent Change
44	Food products and beverages	$ 77,243	$ 82,288	+ 7	$ 229,016	$ 245,245	+ 7
11	Tobacco products	45,153	57,098	+ 26	125,704	142,013	+ 13
38	Textiles and apparel	13,206	15,143	+ 15	53,333	49,355	— 7
31	Paper and allied products	54,336	45,060	— 17	168,322	137,908	— 18
34	Chemical products	202,647	221,966	+ 10	657,641	676,252	+ 3
25	Drugs, soap, cosmetics	76,302	93,825	+ 23	213,856	251,484	+ 18
34	Petroleum producing and refining	649,105	637,472	— 2	1,920,857	2,089,876	+ 9
50	Cement, glass, and stone	92,351	93,576	+ 1	275,114	260,021	— 5
39	Iron and steel	99,382	244,101	+ —	710,991	865,862	+ 22
29	Electrical equipment, radio, and television	85,296	104,518	+ 23	243,281	321,151	+ 32
58	Machinery	71,215	75,628	+ 6	227,826	244,348	+ 7
99	Other metal products	186,931	176,351	— 6	665,845	553,716	— 17
32	Automobiles and parts	158,395	217,807	+ 38	884,356	1,036,907	+ 17
25	Other transportation equipment	40,461	43,764	+ 8	129,647	146,183	+ 13
60	Miscellaneous manufacturing	91,124	92,907	+ 2	272,061	268,203	— 1
599	Total manufacturing	1,943,147	2,201,499	+ 13	6,777,850	7,288,524	+ 8
24	Mining and quarrying	41,461	34,284	— 17	134,104	124,139	— 7
35	Trade (retail and wholesale)	32,466	37,016	+ 14	87,450	99,852	+ 14
19	Service and amusement industries	14,494	16,426	+ 13	40,028	46,139	+ 15
54	Railroads	194,808	173,124	— 11	561,241	492,769	— 12
76	Electric power, gas, etc.	153,510	170,760	+ 11	565,200	599,441	+ 6
3	Telephone and telegraph	192,785	211,368	+ 10	568,190	641,278	+ 13
810	Total	$2,572,666	$2,844,472	+ 11	$8,734,063	$9,292,142	+ 6

† Increases or decreases over 100% not computed.

crease of 11 per cent from the preceding quarter but an increase of 11 per cent over the third quarter of last year. The number of companies having decreases from the preceding quarter outnumbered those with increases 3 to 2, but in comparison with the third quarter of a year ago the increases outnumbered the decreases in the same ratio. The favorable comparisons with a year ago were due in part to the fact that the third quarter of 1956 included a number of adverse factors — particularly the steel strike and curtailment of output to correct inventory accumulation in automobiles — making that quarter the poorest of the year.

For the first nine months, combined net income of these companies was up 6 per cent from the same period last year, with the number of increases in the majority 3 to 2. The condensed summary above gives comparative figures by major industry groups.

Of the 15 manufacturing subgroups, 9 showed increases over last year in both the third quarter and first nine months. In other lines, there were increases over last year in net income of both periods for electric, gas, and telephone utilities, as well as for trade, and for the business service and amusement industries. In the case of the railroads there were moderate decreases.

Trends in Manufacturing

For the 599 manufacturing companies in our tabulation, total net income for the first nine months was up 8 per cent over last year, although among the major industry groups the results, as shown in the table, were widely mixed.

A majority of the food processors had moderate increases in both sales and net income, while the tobacco companies continued their uptrend in gross and net. In the drug-soap-cosmetic group the earnings of numerous companies rose to new highs. Petroleum producers and refiners extended their growth, but for the third quarter alone there was a small dip in earnings under '56 as a result of excess stocks and product price weakness.

Although the iron and steel company group was ahead of last year for the first nine months, most of the gain occurred in the third quarter and represented a recovery from the strike in the corresponding period of '56. The latest quarter as compared with that preceding was down by 20 per cent, reflecting the rise of costs faster than revenues.

Manufacturers of electrical apparatus enjoyed sharp increases in shipments, while makers of machinery generally benefited from the demand for all types of labor-saving equipment designed to hold down operating costs. Some of the automobile and parts producers achieved vigorous gains in sales and earnings, although some others experienced a dip in net because of higher costs

An increase of somewhat less than average proportion for the nine months was registered by the important chemical group, which achieved a moderate increase in sales billed but suffered some pinch in profit margins.

In five groups the net income for the first nine months was below that of last year, although results among individual companies were extremely uneven. Sales of the textile producers were slightly ahead of 1956 but net was lower, despite some improvement in the latest quarter. In the paper industry, where the great plant

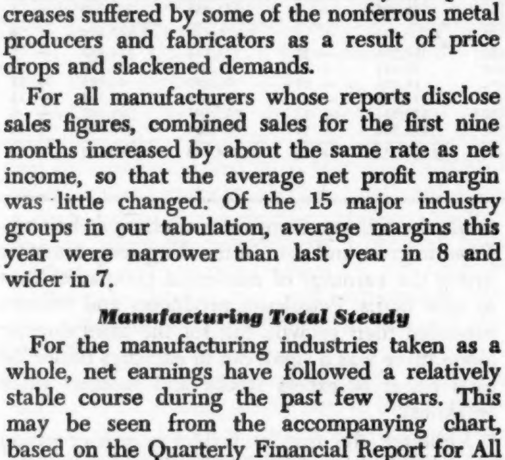
expansion program during recent years has greatly increased productive capacity and intensified competition, a majority of the reporting companies had lower earnings.

The cement-glass-stone companies have been faced with slackened demand because of a lag in residential building construction, an extended strike at cement plants, and rising costs generally. In the "Other metal products" group, which includes a variety of products not elsewhere classified in our condensed quarterly summary, the decline in total was accounted for by sharp decreases suffered by some of the nonferrous metal producers and fabricators as a result of price drops and slackened demands.

For all manufacturers whose reports disclose sales figures, combined sales for the first nine months increased by about the same rate as net income, so that the average net profit margin was little changed. Of the 15 major industry groups in our tabulation, average margins this year were narrower than last year in 8 and wider in 7.

Manufacturing Total Steady

For the manufacturing industries taken as a whole, net earnings have followed a relatively stable course during the past few years. This may be seen from the accompanying chart, based on the Quarterly Financial Report for All U.S. Manufacturing Corporations compiled jointly by the Federal Trade Commission and the Securities & Exchange Commission. Figures became available last month through the second quarter of 1957.



Net Income After Taxes of All U.S. Manufacturing Corporations, with Average Annual Percentage Rates of Profit Margin on Sales and Return on Net Assets. Latest Plotting Second Quarter 1957.

In the case of the dollar totals of net income after taxes it will be noted that, aside from the moderate quarterly fluctuations, there has been a progressive slowing of the rise which began in 1954. Some reduction from 1956 is indicated this year in the average percentage rates of profit margin on sales and return on assets.

The percentages shown are annual rates, computed from the quarterly figures without allowance for seasonal variation. The over-all profit margin averaged 5.3 per cent of sales in the year 1956, and narrowed slightly to 5.1 per cent in the first quarter this year and 5.0 per cent in the second quarter. The return on net assets or stockholders' equity averaged 12.3 per cent last year, and in the first two quarters of this year declined to 11.9 and then to 11.6 per cent.

The ratios thus show symptoms of difficulty for manufacturers in absorbing cost increases provided in wage contracts. A continuance of this trend may test the solvency of some marginal enterprises and generally stiffen resistance of employers to such rapid increases in wage costs as we have had over the past two years.

Sputnik

The Soviet Government on October 4 opened celebrations of its fortieth anniversary by shooting off a great skyrocket. Even as these words are written, it has still to return to earth or consume itself in flames. The first man-made satellite — "Sputnik" — is rotating on an eccentric orbit, circling the earth at several hundred miles altitude and at a speed of 18,000 miles per hour.

However long or short the life of the satellite, Sputnik ranks as a major breakthrough of applied science. It aroused great interest throughout the world in the practical possibility of space-stations and space-ship trips to the moon. As advertising of Soviet scientific prowess, the effect was enormous. It made the conventional propaganda efforts of the U.S. Information Service seem pedestrian and implausible.

Sputnik came as a great shock to the American ego. As Dr. Vannevar Bush, chairman of the Massachusetts Institute of Technology, said, "we are altogether too smug in this country." Work was speeded on the Navy's "Vanguard" satellite program, now in a testing phase. Pressures developed to provide the Defense Department with more funds for basic research and rocket-powered bomb projects. Suggestions were offered that tax reliefs, shaping up for 1958, might have to be foregone. Some sections of the press urged abandonment of money limits on expenditures for rocket development — in other words, trying to beat the Russians with inflation.

The excitement of our failure to be first in reaching outer space made many people forget

that this is not a military project. The Congress has never endorsed the idea that the people should be taxed to build space-ships. There have been many more urgent needs for funds here on earth. Thus, some experimental work done in 1946-47 was abandoned. Russia tapped this pool of data through their spy system. During World War II they had captured and stripped Peenemuende, the east German rocket-manufacturing center.

The U.S. Program

American work on a satellite (Vanguard) began in 1955 for completion and launching before the end of the International Geophysical Year on December 31, 1958. The appropriation for the project, which had been originally figured to cost $10 million, totals $110 million of which approximately half has been spent. The purpose is to learn more of the earth and the nature of outer space; it has nothing directly to do with defense. As President Eisenhower emphasized at his October 9 press conference:

> The rocketry employed by our Naval Research Laboratory for launching our Vanguard has been deliberately separated from our ballistic missile efforts in order, first, to accent the scientific purposes of the satellite and, second, to avoid interference with top-priority missile programs. Merging of this scientific effort with military programs could have produced an orbiting United States satellite before now, but to the detriment of scientific goals and military progress. . . .
>
> Our satellite program has never been conducted as a race with other nations. Rather, it has been carefully scheduled as part of the scientific work of the International Geophysical Year.

The military effort is compassed in accelerating and incomparably heavier expenditures for missiles using rocket power to carry bombs to specific targets.

Total outlays under all rocket and ballistic programs are now exceeding $200 million a month. The missile problem is more complicated for it involves not only sending up a rocket but carrying a bomb to hit a specific target hundreds or thousands of miles away. In the present state of knowledge, airplanes still provide the surest means of delivering bombs on a distant place. However great the values for progress of pure and applied science, the nation cannot be defended today with the weapons of tomorrow.

Military programs involving years of effort and development cannot be upset by every passing fancy. If they were we would always be in a state of unreadiness. The shifting emphasis of the defense establishment, under the administration of President Eisenhower and Defense Secretary Wilson, is set out in the following table comparing projected outlays in the fiscal year 1958 which began on July 1 with actual outlays in fiscal 1952. This brings out increasing emphasis on aircraft and on missiles. While the level of total expenditures is modestly lower, it should be borne in mind that we were actively engaged in the Korean War in the earlier year.

Defense Department Military Spending

(Dollar Figures in Millions)

	Fiscal 1958 Estimated Amount	%	Fiscal 1952 Actual Amount	%
Military Personnel Costs	$10,345	27.2	$11,152	28.6
Operation & Maintenance	9,465	24.9	11,682	30.0
Major Procurement				
Aircraft	7,158	18.8	4,888	12.5
Missiles	2,541	6.7	169	0.4
Ships	1,100	2.9	624	1.6
Vehicles	283	0.8	1,914	4.9
Artillery, Weapons, and Ammunition	388	1.0	1,677	4.3
Electronics & Communications	770	2.0	597	1.5
Other Procurement	845	2.2	1,609	4.1
Military Public Works	1,845	4.9	1,819	4.7
Reserve Components	1,197	3.2	476	1.2
Research & Development	1,680	4.4	1,164	3.0
Other Defense Department Activities	388	1.0	1,201	3.1
Total	$38,000	100.0	$38,972	100.0

The unique achievement of Soviet science lies in getting a rocket up to an altitude and directing it into an orbit with a speed that neatly matches off centrifugal force with gravitational pull. This is something, evidently, American applied science has not yet been able to work out. But it does not follow that all is lost for this country and for the free world.

We should not overlook our own missile accomplishments. A year ago this country launched a rocket that went up more than 625 miles and traveled 3,600 miles. Hanson Baldwin, military editor of *The New York Times*, summed up our progress this way October 13:

> The United States has rocket motors considerably more powerful than those required to launch an earth satellite; those used in the Atlas for instance produce a total thrust of about 335,000 pounds. We have also fired at least one missile – the Jupiter C – probably as far as the Russians have fired their longest range missile.
>
> Moreover, we appear to have solved the "re-entry" problem; in other words we have developed an aerodynamic shape with a nose cone that permits the warhead to return to earth without burning up and disintegrating because of the heat generated by friction in its passage through denser air.

And just a week ago the Air Force fired a rocket which is calculated to have reached an altitude beyond 2,700 miles (against Sputnik's 580 miles).

How Did They Do It?

The Russians have proved with their satellite that they have developed more than enough rocket power for any earthly uses. Should they apply this power to transport themselves in space-ships to Mars one could only wish them Godspeed. As the London *Daily Telegraph* remarked: "The Russian people go from peas-

ants to space-men without ever tasting the joys this earth can offer."

In developing Sputnik the Russians built upon the scientific progress of many men and nations. That they carried theory through to the practical achievement is a credit to the quality of education in mathematics and science in Russia.

After the Russian satellite flew off into space the President had a long meeting with a large group of eminent scientists. He said he was "a bit astonished" to find their chief concern was not with our relative position in scientific advancement today, but where we are going to be in ten years. The President endorsed the scientists' view that we have a problem of "awakening America" to "the absolute necessity of increasing the scientific output of our colleges and universities."

What the universities can do depends on the preparation of secondary school education. The most solid benefit of Sputnik could be to repair the quality of our high school curriculum and re-emphasize mathematics and science as required subjects. Back in January, the Sixth Annual Report of the National Science Foundation to President Eisenhower warned that U.S. leadership in technology "could no longer be taken for granted" in the light of Russian emphasis on science and mathematics, particularly in the secondary schools.

Dr. Harold W. Dodds, recently retired president of Princeton University, is another authority who is concerned by the leveling of public school programs in favor of "easy knowledge, lax instruction, over-emphasis on extracurricular activities and other escapes." Lord Rutherford, the distinguished British physicist, once said of the modern man: "We're going to have trouble with these people. Not only are they not going to know how an electric light bulb works, but they're going to be proud of it."

The Soviet Union has departed from the Marxist principle of "from each according to his abilities, to each according to his needs." It gives stimulus to the efforts of scientists by providing them material comforts far beyond the ordinary living standards of the people. It makes sparing use of progressive income taxes which in the Western world cut rewards for gifted individuals so sharply.

Finally, the Russians got their satellite by a tremendous concentration of effort and giving the project a top priority. Men and material are limited in Russia just as they are elsewhere.

The Nutter Study

The Soviet "moon" must be viewed in perspective; all elements in the picture must be considered. The satellite's dazzle should not blind people to the fact that Russia's rate of progress, over all, has had nothing in common with Sputnik's speed through space.

Some people are inclined toward the conclusion that Russia is catching up to us in all departments of scientific and industrial activity. According to *The New York Times*, Congressman James E. Van Zandt made the startling suggestion on October 17 that within ten years the Soviet Union might match the United States in industrialization, scientific progress, and standard of living. Examination of Russian data fails, however, to confirm this conclusion.

A National Bureau of Economic Research study by Professor G. Warren Nutter of the University of Virginia, released September 23, concludes that, in 37 industries studied, Soviet production in 1955 typically lagged about 35 years behind the United States. This means, theoretically, that Russian industry is about where we stood in 1920. Professor Nutter finds that, while the Soviets have been moving ahead faster in some industries, Soviet industry more commonly has progressed less rapidly than ours did from the same stage of development. On the basis of the sixth five-year plan, in force when the study was made, Professor Nutter figured that Russia by 1960 would still be 20 years behind the United States in total output and 48 years behind in per capita production. According to Harry Schwartz, writing in *The New York Times* for October 20, the objectives of this five-year plan have had to be scrapped "to make possible the space satellite and attain other political and military objectives."

What Should We Do?

Any one of a number of nations, willing to make the sacrifice in the standards of living of its people, or in other productive achievements, might have been first with a man-made "moon."

To no other nation, probably, was the effort worth the cost. The U.S. Congress, properly more concerned with weapon development, at no point had pressed a speedier development of a satellite. The Soviet Union saw and seized a rare opportunity to advertise to the world its scientific know-how and to imply a corresponding leadership in weapon development. Thus, Sputnik looms as a great victory in psychological war.

But the satellite also shows what a totalitarian government can accomplish, denying to the mass of its people what we would consider a decent standard of living, milking the resources of its earthly satellites, and concentrating efforts. The United States would be ill-advised to join a battle of braggadocio and put satellite and space-ship

projects ahead of military striking and defensive power. President Theodore Roosevelt laid down a wise dictum: "Speak softly but carry a big stick."

Another way to give comfort to the Marxists would be to postpone indefinitely reliefs from the extreme rates of income taxation which are placing such a difficult burden on the accumulation of private capital, incentives to the singularly gifted individual, and new business growth in the United States.

Need for Fiscal Control

Although responsible officials deny that money limits have held back rocket development, the temptation is strong to find the answer to the Soviets in inflationary deficit financing. Senator O'Mahoney espoused this point of view when he said that our defense plans seemed to be based on "meeting the enemy at the seacoast with a balanced budget."

There is a real possibility that Congress, in deference to public excitement, will be inclined to appropriate any sums that might be requested for rockets. It has been said that the generals and admirals would ask for the moon if they thought that they could get it. In the present instance they might have a Congress willing to say yes.

The trouble with disregarding prudent fiscal principles is that the inflation which results waters down the value of defense dollars as well as all the rest. Hardly anywhere have costs risen faster than in the area of military "hardware." And scientists are created by an educational process, not by appropriations. What the Defense Department needs to recognize is that the nation cannot afford wasteful interservice rivalries or procurement policies directed at spreading military business rather than using the most efficient contractors.

One of the great popular delusions of our time is that increased federal appropriations are the answer to every problem. Money is nothing if it is not command over resources. If we want more rockets we must have less planes and guns and ships. If we want more defensive strength in all categories we must hasten to reverse the rising course of nondefense expenditures. If the people wanted government to expand on every front they would have to be content with reduced living standards. Collecting in taxes as much as is spent – in other words balancing the budget – is the simple and straightforward way of recognizing these propositions. We are deluding ourselves if we think that deficit financing, in a period of full employment, affords an avenue for escaping limits on manpower resources.

Defense cannot rest on pretense. It must rest on justice and balance, on incentives that produce saving and investment as well as tax revenues to support a strong defensive establishment. Behind the essential weapons of war, the self-reliant individual, working and studying to get ahead, adjusting himself to changing circumstances and adversities, is the invincible power of America.

Federal Spending, Debt and Taxes

Difficulties of reducing federal spending to release budget revenues for debt retirement and tax relief were highlighted in the revised estimates released by the Bureau of the Budget October 1 after the adjournment of Congress. Despite Congressional budget cutting, the Budget Bureau's review raised the fiscal '58 expenditure estimate from $71.8 to $72.0 billion. Meanwhile, Russia's successful launching of its earth satellite led to demands that Congress give up economy efforts entirely on the theory – denied by President Eisenhower and Defense Department experts – that U.S. missile development has been hampered by lack of funds. This would obviously rule out tax relief next year, on which so many people have been counting. Hardly anything could bolster sagging business sentiment more soundly at this juncture than a universal paring of income tax rates within a balanced budget. This is the consideration that is figuring in the work, now underway, of preparing the budget for fiscal '59, beginning next July 1.

The Administration has been planning to hold fiscal '59 federal spending within a limit of $70 billion. Questioned at his October 30 press conference, the President confirmed the target but made it clear that this would be no easy accomplishment. He revealed that in current fiscal '58 military spending is likely to run $400 million or more above the $38 billion budget allocation. Achievement of a $70 billion over-all budget next year, he said, "would require very serious retardations" in other government programs.

The $70 billion goal would be $2 billion below the spending projection for current fiscal '58 but $700 million more than was spent in fiscal '57, the last complete fiscal year.

The latest official estimates for fiscal '58 are compared in the following table with the initial '58 estimates last January and with actual results in fiscal '55, '56 and '57.

Federal Budget Expenditures and Receipts
(In Billions of Dollars)

	Fiscal Years Ended June 30				
	1955 Actual	1956 Actual	1957 Actual	1958 Jan. est.	1958 Oct. est.
Expenditures	$64.6	$66.5	$69.3	$71.8	$72.0
Receipts	60.4	68.1	71.0	73.6	73.5
Surplus (+), Def. (–)	–4.2	+1.6	+1.7	+1.8	+1.5

What made the rise in programmed federal spending for fiscal '58 particularly disappointing was that it came even though Congress and the Administration had cut the President's initial requests for new spending authority by $5 billion. While much of this merely served to reduce backlogs of unused spending authority, projected spending in fiscal '58 was cut by about $2 billion. The trouble is that even these economies were offset by Congress' failure to eliminate the $599 million postal deficit; by increases in projected spending for farm price supports, interest on the public debt and stockpiling of strategic materials; and by Britain's decision to draw on the $500 million Export-Import Bank credit granted last winter during the Suez crisis.

Representative Clarence Cannon, Chairman of the House Appropriations Committees, summed up the record:

> We have cut the fat but not the muscle. As a matter of fact, we could have extracted another $5 billion without material interference with the legitimate functions of government. That will be our goal in the future.

Sputnik and the Budget

Many people have assumed that the appearance of the Russian earth satellite means the end of the economy drive and frustration of hopes for tax relief. President Eisenhower has held to his oft-stated conviction that national security requires a sustained steady effort, not spasmodic panicky reactions. In a speech October 12, Senator Clifford P. Case, Republican of New Jersey, pointed out that:

> It may be that additional funds could fruitfully be applied to our missile and satellite programs. But there are strong indications that inter-service rivalry, lack of coordination between the missile and satellite programs, and honest differences of opinion are at least equally involved.

Senator Mike Mansfield, Democrat of Montana, took a stronger stand:

> We have plenty of money to spend on missiles and satellites without going above the $38 billion defense spending ceiling set by the Administration for this fiscal year.

Senator Mansfield would pool all our missile efforts in one coordinated program to eliminate duplication and waste.

At the same time there is widespread agreement with the view expressed by Vice President Richard M. Nixon in a speech October 15: "Let us resolve once and for all that the absolute necessity of maintaining our superiority in military strength must always take priority over the understandable desire to reduce our taxes."

The fact is, however, that debt retirement and tax relief could be achieved without touching the defense budget. The key is to cut back the swollen level of nondefense spending which is now projected at a record $27.9 billion, up no less than $5.4 billion or 23 per cent since fiscal '55. This is the approach being taken by the Administration.

The following table shows the startling percentage increases in nondefense spending programs since fiscal '55. Projected spending on International Affairs and Finance is up 115 per cent. Commerce and Housing expenditures are slated 44 per cent higher than actual outlays in '55. Labor and Welfare spending is figured for a 32 per cent rise.

Major Federal Spending Programs, Fiscal 1955 and 1958

(In Millions of Dollars)

	1958 Est.	1955 Actual	Change from 1955 Amount	Change from 1955 Per Cent
National Security	$44,100	$42,090	+2,010	+ 4.8
Int'l Affairs and Finance	1,546	718	+ 828	+115.3
Veterans' Benefits	4,982	4,457	+ 525	+ 11.8
Labor and Welfare	3,369	2,552	+ 817	+ 32.0
Agriculture	5,026	4,411	+ 615	+ 13.9
Natural Resources	1,385	1,202	+ 183	+ 15.2
Commerce and Housing	2,168	1,502	+ 666	+ 44.3
General Government	1,360	1,201	+ 159	+ 13.2
Interest	7,861	6,438	+1,423	+ 22.1
Reserve for contingencies	200	—	+ 200	—
Total	$71,997	$64,571	+7,426	+ 11.5

It will not be easy to cut these programs. They all have entrenched supporters who benefit from them. But if the will for economy is there, the interest of the large mass of taxpayers should prevail. The basic question is whether nondefense spending should be running at record levels in competition with the national security needs of the nation, increasing upward pressures on the price level, and perpetuating a high rate tax system shot through with inequities and disincentives.

Reducing the National Debt

Holding back government expenditures is the best medicine for inflation. Representative Wilbur D. Mills' Subcommittee on Fiscal Policy concluded last June after public hearings that:

> Under present conditions of high levels of employment and output, any modest surplus in the Federal budget should be applied to debt reduction. In addition to facilitating public debt management, this use of a budget surplus will reduce the demands imposed on monetary policy as a means of restraining inflationary pressures.

In other words, defer tax reductions until something more than a "modest" surplus is in sight. Senator Byrd, who, in his strategic position as Chairman of the Senate Finance Committee, has made the $275 billion public debt limit an effective restraint on federal spending, suggests $2 billion a year as a proper provision for debt retirement.

Others, wanting faster debt retirement, oppose any measures of tax relief as "inflationary."

This attitude is not wholly realistic. It ignores the fact that present taxes involve serious inequities and hazards to national strength and progress. Over-rapid debt retirement could dislocate the economy and precipitate a violent downturn in business under the double influence of contracting government outlays and an unreformed tax structure.

Reducing expenditures and taxes is the way to pare the national debt. Well-designed tax rate reductions, encouraging people to earn and report taxable income, rarely cost as much in revenue loss as they are calculated to do. It was the experience of the 1954 tax and expenditure reductions that lower taxes reinvigorated the economy, rebalanced the budget, and stabilized the dollar. The experiment needs repeating.

Inflationary Public Expenditures

A rising curve of government expenditures can support employment opportunities in an economy overloaded with taxes, but only at the cost of constricting opportunities for private enterprise while giving impulse to inflation. We have seen this over the last two years. As government demands rise, they pre-empt goods and services people want to buy and enjoy. So people demand more income in the hope of improving their well-being. But the people cannot win, for government takes in taxes a bigger slice of the increased income and spends still more. This is the route to creeping inflation and not to sound progress.

At the Senate Finance Committee hearings, the then Secretary of the Treasury, George M. Humphrey, explained the inflationary influence of increased federal expenditures even when covered by revenues:

> Government expenditures are inflationary, particularly when the economy is at a high level of output and employment. Taxes divert to Government spending some funds which, in the hands of the taxpayer, would have gone into savings. Furthermore, some Government expenditures go into payrolls to produce goods and services (especially military equipment and services), which neither contribute to the Nation's capital account nor become available for private consumption. Yet this additional purchasing power competes for the existing supply of both goods and services.

Thus, a combination of reduced government outlays and tax rates, in the net, can relieve over-all inflationary pressure while stimulating private risk-taking enterprise and adding to take-home pay. Few people realize how high taxes have become built into the price structure and how fully they figure in the high cost of living.

In any case, the thesis that tax cuts are inflationary hinges on the idea that federal expenditure programs are irreducible. This is contrary to fact. Practically every government program has some fat in it and Congress knows there are programs that can be dispensed with entirely if there is no money for them.

Urgent Needs for Tax Reform

Representative Richard M. Simpson, House Ways and Means Committee member from Pennsylvania, urged October 17 that, despite the furor created by Sputnik, an income tax cut next year is "mandatory if the economic needs of a growing nation are to be met." Discontent with the present structure of federal income taxes is well-nigh universal. The Committee for Economic Development, in a recent policy statement, *Tax Reduction and Tax Reform,* described the way current tax revenues are raised as "economically unsound and unfair." *Business Week* last May gave a crisp diagnosis of what is wrong with taxes in America:

> As it stands, the U.S. tax system is not a system at all – in the sense of being a consistent body of levies based on some general principles and designed to produce the most revenue with the least disturbance to the economy. Instead, it is a loose collection of emergency measures that Congress has rammed through at one time or another in a desperate effort to meet some fiscal crisis. Built into these hastily-drawn and often contradictory laws are a variety of exceptions and exemptions, some deliberate, some accidental, some carefully engineered by various pressure groups.
>
> The result is a tax structure that exalts the loophole-artist and distorts the normal course of economic growth. This is morally wrong and economically dangerous.
>
> What we need and need most urgently, is to overhaul the system from top to bottom – cleaning out the inequities, introducing more flexibility, removing the contradictions. What we need, in other words, is thorough-going tax reform.

There has been little question for years but that the height of income tax rates is the crux of the problem. The Administration gave assurances when the Revenue Act of 1954 was passed that rate reductions would be the next object of action. Since then, some of the most persuasive arguments for reconstructing the rate structure have come from people who helped set up the confiscatory rates and now see the evil consequences. For example, Stanley Surrey, Tax Legislative Counsel to the Treasury from 1942 to 1947 and now professor at the Harvard Law School, in an article in *Collier's* in March 1956, concluded:

> Only when we have lower tax rates will we be rid of the special privileges and tax dodging that high rates create.
>
> Only when we have lower tax rates will management and investors be free to make decisions on the basis of business factors and not of tax lures.

Yet action has been deferred. The question is how long we can afford to wait.

The Sadlak-Herlong Plan

A good deal of interest has been stimulated in a tax relief plan introduced last March 28 by Congressman Antoni N. Sadlak, Republican of Connecticut, a member of the House Ways and Means Committee. Representative Sadlak would schedule in advance cuts in individual and corporate income tax rates on the principle that only in this way can we forestall the "strong pressures within and without the government for spending the revenue increase resulting from economic growth instead of applying it to tax reduction":

> I believe that the time has come when Congress, in response to the urgent needs of the country and the ever growing concern of our constituents, must seriously review the problem of high taxes which are being used to support more and more Federal spending. The time has come to enact a realistic program of forward scheduling of tax reduction for all income taxpayers, individual and corporate.

In introducing his bill, Mr. Sadlak pointed out that the growing dissatisfaction with the rate structure goes much deeper than normal taxpayer irritation with a heavy tax load: "It reflects a growing recognition that there is something fundamentally wrong with a tax structure which penalizes hard work, risk taking and achievement."

In reference to small business, for which so many tears are shed in Washington, the Congressman had this to say:

> The problem is entirely a matter of rates. Both as regards unincorporated businesses, which approximate 84 per cent of the over 4 million business units in the country, and the owners of incorporated small business, the major tax impediment is the system of steeply graduated rates of individual tax – the rates which begin with 22 per cent on taxable income between $2,000 and $4,000, increase rapidly to a rate of 50 per cent on taxable income between $16,000 and $18,000 and go on up to a top rate of 91 per cent. The incorporated firms have the additional problem of the corporate tax, especially the combined top rate of 52 per cent which applies to income over $25,000.
>
> None of the special devices previously suggested for aiding small business effectively deal with the real source of the problem. Any and all of them would set up new inequities and discriminations within the tax laws. Many of them would add greatly to the complexity of the laws. By contrast, a moderate scale of individual and corporate rates would solve the problem with fairness and equity for all.

Taking up the current scarcity of capital, Congressman Sadlak stated flatly:

> This nation has a severe shortage of new capital, and especially venture capital, because the tax laws are designed to produce such a shortage. The extremely severe rates in the middle and higher income brackets are an especially limiting factor on the accumulation of new capital for investment in new and growing enterprises.

He concluded that:

> The time has come to bring an orderly plan for reducing the rates which discourage individual effort, prohibit adequate savings, and threaten the industrial vitality and supremacy of our nation. Even under a fair and moderate rate structure, our economy may be hard-pressed to generate all the savings needed to meet all opportunities to advance production and living standards without inflation.

Representative A. Sidney Herlong, Democrat from Florida, who gave Mr. Sadlak's bill bipartisan sponsorship by introducing an exactly identical bill on August 8, made this latter point in even stronger language:

> Certainly, the Federal Government is in an untenable position when it holds itself forth as the protector of the people from inflation on the one hand, and on the other does not forthrightly consider and deal with its own policies which foster inflation. Excessive use of bank credit is the engine of inflation, but under present circumstances this engine is fueled by the arbitrary restriction on savings imposed by the unfair and unsound tax rates.

Five-Year Rate Reductions

The Sadlak-Herlong proposal, accordingly, would provide for annual reductions in income tax rates over five years. The 52 per cent corporation income tax rate would be cut 2 points a year to 42 per cent at the end of five years, with the normal tax rate of 30 per cent falling to 22 per cent and the additional surtax rate of 22 per cent applicable to income over $25,000 reduced to 20 per cent.

Even a 42 per cent regular corporate income tax rate would be higher than U.S. corporations ever had to pay prior to the Korean War. Furthermore, the standard 52 per cent U.S. corporate tax rate compares with 45½ per cent in the United Kingdom, 45 per cent in Canada, 45 per cent in Germany and 40 per cent in Australia. Corporate income distributed in dividends is sometimes taxed at differentially higher or lower rates than these.

Representatives Sadlak and Herlong would cut the rate applicable to the first $2,000 of individual taxable income 1 point a year to 15 per cent at the close of the five year program. Rates applicable to income above $2,000 would be graduated upward, but would rise much more slowly than the present schedule. For example, income between $16,000 and $18,000, now taxed at a 50 per cent rate, would be taxed at 45

per cent the first year and finally at 23 per cent. The confiscatory rate of 91 per cent applied to income beyond $200,000 would fall to 82 per cent initially and to 42 per cent at the end of the program. The following table shows, for individuals in selected taxable income brackets, the current rates and the schedule of new rates proposed by Representatives Sadlak and Herlong.

Current and Proposed Individual Income Tax Rates

Taxable Income ($ Thousands)	Present Rates	Rates under Sadlak-Herlong Proposal 1st yr.	2nd yr.	3rd yr.	4th yr.	5th yr.
$ 0 — 2	20%	19%	18%	17%	16%	15%
4 — 6	26	24½	23	21½	20	17
8 — 10	34	31	28	25	22	19
16 — 18	50	45	40	35	29	23
32 — 38	65	58	51	43	36	28
50 — 60	75	66	57	48	39	31
90 — 100	87	76	66	56	46	36
200 — and over	91	82	72	62	52	42

These reforms would get us away from rates which tell the citizen to restrain his productive work effort and turn his attention to finding deductions and avoiding tax.

The 10-point cut in corporate rate is figured to cost $4.2 billion, at 1956 income levels, and the individual tax cuts $10.6 billion. The calculated cost to the Treasury of the full five-year program works out to almost $15 billion. This is a formidable total. Yet, as Mr. Sadlak points out, budget revenues under existing tax rates have grown from $60.4 billion in fiscal year 1955 to $71.0 billion in fiscal year 1957, for a net gain of more than $10 billion in just two years. He concludes that it is reasonable to expect that we could make the scheduled reductions without actual net revenue loss to the Treasury:

> Based on 1956 income levels, it would take annual revenue growth of only about $3.0 billion a year to accomplish the scheduled rate reductions without net revenue loss to the Treasury. If the economy grows in step with the recent historic average, the revenue growth should average up to $4.0 billion a year without inflation.

A major objection to advance scheduling of tax cuts has been the fear that the reductions might be required when the revenues were insufficient. This is taken care of in the Sadlak bill by built-in postponement procedures under which the President and Congress could spread out the five year program of tax cuts over a nine year span if necessary. Thus, provision is made to avoid tax cuts at the expense of deficit financing.

The Long View

Chairman Jere Cooper of the House Ways and Means Committee will open hearings next January 7 to re-examine the basic policies underlying our tax laws. Among the matters requiring attention are:

1. The tendency of federal expenditures to mount and exclude opportunities for tax reductions and debt retirement.

2. The tendency, under a progressive rate structure, for the effective tax burden to rise and steal away the fruits of progress from the people.

3. The corrosive effects of the higher rates on individual will to work and save, on risk-taking enterprise, on taxpayer morality, and on the revenues themselves.

4. The ability of American industry to hold leadership in world markets under the double disadvantages of top-scale wages and top-scale taxes.

It is too often forgotten that the main argument originally used to justify steep progressive rates was that they would discourage savings. However appropriate this was in the 1930's atmosphere of secular stagnation, it has no place in the expanding America of the 1950's where the watchword is growth.

Dr. Solomon Fabricant, director of research of the National Bureau of Economic Research, estimated three years ago that, if the growth trends of the past continue, average family income in the United States might rise to $25,000 over eighty years. Under the current schedule of progressive tax rates, this would put the average family into the 38 per cent tax bracket. A single person, without the special relief of income-splitting, would find himself in the 59 per cent bracket. More and more above-average individuals, in business, government, the arts and professions, would face punitive 70, 80 or 90 per cent rates.

Could anyone seriously expect the economy to keep growing in this kind of a straitjacket? Uncorrected, the present steep progression of rates will gradually suffocate the economy as a whole, just as it is already suffocating opportunities and incentives for the gifted individual.

As former Treasury Secretary Humphrey told the Congressional Joint Economic Committee last February:

> . . . our present tax rates are too high. I believe — I can't prove this, and only time will tell — but I firmly believe that if we retain our present high tax rates with no reductions in them, over a sufficiently long period of time, we will not be able to carry on the development which is required in this country to give jobs to our people.

What we need is a tax plan designed, not to release inflationary spending power, but to reinvigorate productive work effort.

n U.S.A.